ENTERPRISE AND PROFIT.

SINCE the appearance of my article in this Journal for April, 1892, in which I advanced the theory that "enterprise," or the assumption of risk, was the distinguishing function of the *entrepreneur* (or, as I would prefer to call him, the "enterpriser" *), and that profit, in the strict economic sense of the term, was the economic reward for services rendered by the assumption of industrial risks, an interesting though somewhat desultory discussion of the allied subjects of risk, speculation, and insurance has been carried on.†

Although much that I advanced in support of "The Risk Theory of Profit" has been generally accepted, I cannot flatter myself that the theory itself has wholly commended itself to students of the science. Nevertheless, my ideas on the subject seem to have obtained a sort of qualified and ineffective acquiescence; and, so far as I am aware, no other explanation of the nature of indus-

* I have used the word "enterpriser" to denote the person who is entitled to the reward of his enterprise, or risk. If I am correct as to the nature of profit, the word is synonymous with *entrepreneur*, and should be substituted for it, both because it is an English word and because it explains the idea involved much more accurately. The word "enterprise" is in common use as a synonym for a business venture. "Venture" and its derivatives would perhaps answer the purpose; but they do not seem to me as fit, as the idea of purpose does not seem to be so clearly connoted. When we speak of a venturesome person, we imply that he assumes unwise risks,—risks that will probably average against him. Thus we call a gambler or a speculator venturesome, an active business man enterprising. Even if I am wrong about the identity of the *entrepreneur* and the enterpriser, there is still a name needed for the assumer of business risks.

† See the following articles in the *Quarterly Journal of Economics:* "The Fundamental Error of *Kapital und Kapitalzins*," by F. B. Hawley, vi. 280–307; "The Risk Theory of Profit," vii. 459–479; "Insurance and Business Profit," by John B. Clark, vii. 40–54; "The Place of Abstinence in the Theory of Interest," by T. N. Carver, viii. 40–61 (see foot-note on p. 58); "Risk as an Economic Factor," by John Haynes, ix. 409–449. Compare "The Place of the Speculator in the Theory of Distribution," by Professor Henry Crosby Emery, *Papers and Proceedings of the Twelfth Annual Meeting of the American Economic Association*, pp. 103–118, with remarks by President Hadley, Professors Carver, Commons, Giddings, Ripley, and Mr. Emerick.

trial profit, equally satisfactory, has been advanced in its place. The whole subject of profit and loss has been so long enveloped in fog that economists seem to have reconciled themselves to the situation, and have fallen into the habit of assuming that this dark corner of the science cannot be hiding anything of real importance. If, however, it turns out that enterprise is really entitled to rank as the equal of the other productive forces,— land, labor, and capital,—its exact nature can hardly be a matter of indifference. And it may well be true that a competent understanding of the industrial force which, in the one respect of being the only directive force, is even superior to the others, will supply the omitted premises which, to the reproach of economics, have so often stood in the way of the practical application of its principles.

Of course, I must not be understood as criticising this general attitude of economic thinkers. If the Risk Theory really forms an adequate explanation of the phenomena of profit and enterprise, the reason that it has not been more warmly welcomed must be found in the manner of its presentation. This paper is, accordingly, written in hopes of clearing up some of the ambiguities and misunderstandings which still surround the following branches of the subject: —

1. The connection between Enterprise and Co-ordination.
2. The relation of Insurance to Enterprise.
3. The relation of Speculation to Enterprise.

The present standing of the Risk Theory of Profit can perhaps best be shown from the following quotation from Mr. John Haynes's article on "Risk as an Economic Factor": * —

> Mr. F. B. Hawley, in a criticism of "Boehm-Bawerk," has advocated the theory that the *entrepreneur's* function is that of the risk-taker, and that profit, his reward, is the pay for risk-taking, or "enterprise." The question whether or not the *entrepreneur* is a risk-

* *Quarterly Journal of Economics*, ix. 423.

taker depends on the conception of an *entrepreneur*. Mr. Hawley's idea is that he is a man in active business affairs who is responsible for the capital he is using, or is the owner of it himself. That the *entrepreneur* is a risk-taker cannot, I think, be questioned if we take the view Mr. Hawley holds, and, indeed, the view generally held, of the nature of the *entrepreneur*. But is the *entrepreneur* the only risk-taker? To be consistent, this view must include among *entrepreneurs* all lenders of money who receive anything above the minimum of interest. It is universally agreed that gross interest contains a loading which is due to the risk encountered by the lender. If, then, Mr. Hawley is logical, the man who loans his funds to hazardous enterprises is an *entrepreneur*. This view has something to commend it, as it leaves the capitalist, as the receiver of net interest, the reward for the employment of capital when used in the safest possible channels. But this is not all. We must consider the question whether the laborer can be a risk-taker. Mr. Hawley himself, in his controversy with Professor Clark, proves conclusively that other things than capital can be risked. Life and reputation, time and future wages, all can be risked. The man who performs the function designated as labor by economists undergoes risk, as well as the possessor of capital. This is too familiar a fact to need proof. It was treated by Adam Smith, where he said, in speaking of different employments, that "the wages of labor vary according to the probability or improbability of success in them." This being true, if Mr. Hawley is to be consistent, he must include among *entrepreneurs* every laborer who is able to exact from society any compensation for assuming a risk. Doubtless such a system might be worked out which would be perfectly logical and consistent with the facts. We might start with the proposition that there are three kinds of cost,— personal exertion, abstinence,—or waiting,—and risk-taking. No man could be found who suffered any one of these costs in its purity, but it would be a logical carrying out of the idea that distribution must go entirely by functions discharged. Though we might construct such a system as this, it is doubtful whether it would be of any value to our science. The problem of distribution with which economists are struggling is, in large part, the problem of what classification of the facts brings out recognized truths most clearly and in due perspective. It seems to me that the method which would make insurance a co-ordinate subject in distribution would have no special merit in this way.

This is a very lucid, comprehensive, and exact statement of my argument. The view of the *entrepreneur*, or

"enterpriser," here attributed to me is exactly the one I am contending for. I hold that all individual incomes are composite, and that it is hard to imagine one that does not contain an element of profit and loss, as there is an element of uncertainty in the income of everybody. Uncertainty and risk are connotations. The one cannot exist without the other. The moment any element is determined, uncertainty ceases. It is therefore only in the undetermined residue that uncertainty inheres. A residue, until finally determined, connotes a risk; and a risk connotes an undetermined residue. The moment a residue is determined, the risk is annihilated. If, therefore, profit is a residue,—and all are agreed on this point,—it must, when finally realized, be partially, at least, the result of a risk assumed.

It also seems to me a little unfair to demand of a proposed theory of profit what no one ever thinks of demanding of the theory of rent or the theory of wages or the theory of interest. Where is the landlord to be found who is not also a capitalist and a laborer? Where is the laborer who does not possess at least a pair of overalls or a dinner-pail, and, perhaps, even a patch of land? Where is the capitalist who is not also a laborer or a landlord? Yet we find no difficulty in differentiating landlords, laborers, and capitalists, according to their predominant industrial functions. To my mind the fact that any given theory of profit was founded upon a function exercised by individuals who exercised no other industrial function would induce suspicion rather than assent.

Again, I am disappointed that, having gone with me as far as he does, Mr. Haynes objects that "it would be the logical carrying out of the idea that distribution must go entirely by functions discharged."

Of course, the distribution of the product among those who produce it can be arranged under a number of classifications. Aided by statistics, we might determine how

much those between certain ages received or what proportion of it went to males and what to females. For certain purposes these or similar classifications might be useful, but such purposes will always be found to lie outside of the subject of income itself. I must confess myself unable to comprehend how income can be analyzed at all except by means of a classification founded upon function, nor how, when a function is recognized as distinct from all others, it can be refused a place in the classification of functions, even if it is seldom or never exercised by any individual who is not also exercising another function.

Surely, the functions of land, labor, and capital, are universally regarded as causing the distribution of the product into rent, wages, and interest. The landlord bases his claim for rent upon his possession of the land, the laborer his claim for wages upon his expenditure of physical effort, the capitalist his claim for interest upon the productivity of his capital. Both Professor Clark and Mr. Haynes grant that enterprise exercises a serviceable and, therefore, a productive function distinct from all others. Why, then, is not the assumption of the risk, inevitably involved in dynamic production, a sound basis for the enterpriser's claim for a separate reward distinct from all others, even if we refuse to identify him with the *entrepreneur?*

Mr. Haynes fears that the recognition of enterprise as the basis of profit will not be fruitful. It could well be asked, How can he be sure of this before economic doctrine has been reconsidered in the light of the new principle? Moreover, as pure interest is certainly not over two per cent., and as the gross return of interest and profit is certainly over six per cent., the aggregate amount of profit is surely twice and possibly three or four times as large as the aggregate of pure interest. A correct theory of profit, therefore, should be at least as im-

portant to the science as a correct theory of interest. But, granting that his apprehensions are realized, is any reason thereby afforded for denying its proper place to a valid principle? We have usually in economics several classifications to choose from, any one of which may surpass the others for certain purposes and be inferior to them for other purposes. In such cases, of course, we enjoy liberty of choice; but we are never authorized to use part of one classification conjointly with part of another. We cannot, therefore, treat rent, wages, and interest as fundamental forms of industrial income founded on function, while refusing to place the reward of enterprise by their side, unless we can demonstrate that the latter is not a distinct form of industrial income also founded on function. And that it is such is admitted by both Mr. Haynes and Professor Clark.

Fortunately, Mr. Haynes, in the closing paragraph of the quotation, gives us an insight into the real reason of his indifference to the reward of risk-taking. He is perfectly correct in asserting that "insurance" is not a subject in distribution co-ordinate with rent, wages, and interest, because insurance is not a form of income at all. Profit or loss is the final result of a risk undergone; insurance, merely one of the means by which certain risks can be avoided or shifted. This distinction will be discussed more at length later in the article.

I now venture to quote from Mr. Haynes's pages the following succinct and clear statement and analysis of Professor Clark's objections to the Risk Theory of Profit: —

We now turn to Professor Clark's criticism of Mr. Hawley. The whole criticism consists in putting forward Clark's peculiar conception of the *entrepreneur*. According to Professor Clark, the reward of risk-taking belongs to the capitalist. The *entrepreneur* is the co-ordinator of capital and labor, nothing more. His reward is pure profit. Professor Clark says: "We have used the term *entrepreneur* in an unusually strict sense, to designate the man who co-

ordinates capital and labor without in his own proper capacity furnishing either of them. Yet our eyes are open to the fact that the living man who performs this function has to do other things also. It is only in the one limited capacity that we have called that of the *entrepreneur* that the man is confined to co-ordinating the elements furnished by others. . . . In performing this function, he contributes to industry nothing but relations. He connects labor and capital with each other in his own establishment. He connects this establishment with others, and makes it do its part in the general industrial system. He becomes the owner of the products of this industry as they are turned out, and sells them in the market for what he can get. In acquiring this ownership, he must pay all the costs entailed in creating the product; and among the costs to be thus defrayed is the entire sum made over to the capitalist as an offset for risk." Professor Clark excludes from the function of the *entrepreneur* every activity which can possibly be classed as labor; and, moreover, the *entrepreneur* possesses "no dollar." Accepting Professor Clark's conception of the *entrepreneur*, the result follows that he is not a risk-taker; for he has nothing to risk. It is admitted that no single example of the pure *entrepreneur* can be found anywhere. This fact seems to me a serious indictment of the conception.

We are not satisfied with the above conception of the *entrepreneur*. It seems it would be better to understand the phrase, "co-ordinator of capital and labor" (which is a very happy expression) in a wider sense. The *entrepreneur* is a co-ordinator in no passive way,— as merely furnishing a relation,— but he is a person of activity. He makes the relation. He must first be a laborer himself. Then he must have a capital of his own, unless he can get the use of capital as a gift from some relative or friend. Because he is both a laborer and a capitalist, he is able to co-ordinate labor and capital.

Up to this point I find myself in exact agreement with Mr. Haynes. When, however, he goes on to say, as he does in the succeeding paragraphs, that the *entrepreneur* is only a "special kind of laborer," I must dissent.

It is not the purpose of this paper to discuss distribution, but it is absolutely necessary to outline as briefly as possible the distributive system before going further in the discussion of our subject. The essentials of production are two,— labor and capital. The man whose distinguishing function in the productive process is personal effort is a laborer, whether he carries a hod or is President of the United

States. A man who possesses wealth which is used productively is a capitalist. If he co-ordinates his capital with his own labor or that of others, he is an *entrepreneur*,— he is a special kind of laborer. All laborers are co-ordinators of capital and labor; but the *entrepreneur* is distinguished from other laborers by the fact that his own capital (or capital borrowed on his credit, which amounts to the same thing) is co-ordinated with labor, while the simple laborer brings nothing but his personal qualities to the productive process. . . .

The question arises, What is profit? Without going into an extended discussion of the matter, we may say that it is the reward that comes to the *entrepreneur* on account of the special advantage which he has to use his talents and employ his capital from the fact that he is both laborer and capitalist. If we can find out what his income would be if he loaned his capital to others, and also sold his services to others in such a way as to run the same risk and perform the same amount of labor as he does as an *entrepreneur*, the difference between his income and the total income which he receives as an *entrepreneur* represents the reward that comes to him from the fact of his double function, and may be called profit.

There is no more reliable thread to serve us as a guide through the labyrinth of economic discussion than a comparison of any apparent result with the corresponding idea underlying popular conceptions. There is surely something intuitive in the accumulated result of the unconscious cerebration of the race. The popular conception of the term "profit" carries with it two inseparable connotations. The first is that profit is a residue; the second, that it is a form of income distinct from and coequal with rent, wages, and interest. Any definition of the nature of profit which violates either or both of these connotations antagonizes our instinctive perceptions, and requires, therefore, exceptionally clear and distinct proof. And I am sure that neither Mr. Haynes nor Professor Clark will object to their conception of profit being tested by the popular connotations of the term.

Now Mr. Haynes certainly violates the second connotation when he speaks of the *entrepreneur* as a "special kind of laborer," as in that case profit must be a special kind of wages,— wages of management, or, at least, some-

thing analogous to wages of management. But wages of management are always either a predetermined sum entering into the *entrepreneur's* cost or are susceptible of predetermination. So it would appear that Mr. Haynes's conception also violates the connotation that profit is a residue unless he can show that the wages of co-ordinating cannot be predetermined, which he will find to be a somewhat difficult matter.

However, in the last paragraph quoted above — the one in which Mr. Haynes answers the question, "What is profit?" — he seems to change his ground. His *entrepreneur* is no longer a "special kind of laborer," but has become a special kind of monopolist, whose gains come to him "on account of the special advantage which he has to use his talents and employ his capital from the fact that he is both a laborer and a capitalist." Now, as I have pointed out elsewhere,* monopoly gains (except, perhaps, in the case of land rentals) are not a distinct form of income, coequal with wages, interest, and profit, because monopoly is only a distributive force, and not a creative or productive force, like land, labor, and capital, or like enterprise, whether we consider the reward of enterprise to be profit or something else. Except indirectly, as such gains serve as a stimulus to invention, the world as a whole is no richer for the gains of monopoly. What accrues to the monopolists is subtracted from the income of the rest of the community. On the other hand (when once private ownership of land has been established), the man who allows the use of his land to another, the man who allows another to occupy his house, who furnishes another with tools, who retains possession of raw material in process, who holds the finished product to await the convenience of the final consumer, who exercises his physical or mental powers in the rendering of services or in fashioning commodities, and also the man who relieves another of a risk which he is better able to

* "The Risk Theory of Profit," *Quarterly Journal of Economics*, vol. vii.

bear than the man he relieves,— each renders a service for which the world is richer, creates utility, and is entitled to a return. Mr. Haynes's second definition of profit therefore violates the connotation that it is a primary form of income.

Moreover, Mr. Haynes's formula for ascertaining profit is theoretically as well as practically impossible of application. The *entrepreneur* cannot possibly sell "his services to others in such a way as to run the same risk" and leave any surplus behind him; for, if he accepted a stipulated sum, he would no longer run any risk at all. It would be simply a case of insurance, such as will be explained later. If, on the other hand, he accepted a stipulated sum as his wages of management or co-ordination, with the added condition that there should be added to or subtracted from that sum the gains or losses of the business as they eventuated, the whole surplus in question would have to be turned over to him. Before the change was made, the undetermined surplus was his; and he would not, of course, abandon it without receiving an equivalent. Being barred by the condition stated from receiving a definite sum as such equivalent, he would demand an undetermined sum equal to the undetermined surplus.

It is not quite clear to my mind what Professor Clark means by co-ordinating capital and labor; and I cannot, therefore, positively affirm that he would accept Mr. Haynes's answer to the query, "What is profit?"* But I am safe, I think, in assuming that he also regards profit as either a species of wages or a species of monopoly gain, or some compound of the two ideas. I at least cannot understand how co-ordination can possibly obtain any other kind of reward. The co-ordinator goes into the

* Professor Clark says, "Defray all the expenses of bringing a product into existence, sell the article for what you can get, and, if you have anything more in your hands than you had at the beginning of the operation, you have a true profit." *Quarterly Journal of Economics*, vii. 41.

market, selects the raw material most suitable for his purpose, buys it at the cheapest possible price. He hires the laborer and puts the raw material in his hands, and tells him what to do with it and how to handle his tools. He furnishes shelter and tools to the laborer, and subjects him to rigid regulations. He takes the finished product, and uses his judgment as to the best market and the best time in which to sell it. His function is the constant exercise of ingenuity and judgment, which, theoretically at least, can be exercised just as well when he has no financial interest in the product as when he is the owner, just as well when he is a hired manager as when he is a principal. In either case, what he personally obtains for the exercise of his ingenuity, watchfulness, and judgment, is of the nature of wages. He is rewarded by wages of management; and, if his ability as a manager is exceptional, his wages will be and should be exceptionally large. They will be augmented, that is, by a monopolistic accretion. Now of course the co-ordinator may be worth more as a co-ordinator to himself than to any other employer, both because he will be less interfered with and because he will naturally work harder for himself than for a salary; but this circumstance does not change the nature of his income as a co-ordinator. Professor Clark's and Mr. Haynes's conception of the co-ordinator includes, of course, more than this. The mistake they make, as it seems to me, is that this something more is not an act of co-ordination. What is it that elevates the mere co-ordinator, the manager, into the co-ordinator in their meaning of the term, which is synonymous with *entrepreneur?* Professor Clark himself tells us (I quote him again): —

> We have used the term *enterpreneur* in an unusually strict sense, to designate the man who co-ordinates capital and labor without in his own proper capacity furnishing either of them. Yet our eyes are open to the fact that the living man who performs this func-

tion has to do other things also. It is only in the limited capacity that we have called that of the *entrepreneur* that the man is confined to co-ordinating the elements furnished by others. Here he is so confined. In performing this one function, he contributes to industry nothing but relations. He connects labor and capital with each other in his own establishment. He connects this establishment with others, and makes it do its part in the general industrial system. He becomes the owner of the products of this industry as they are turned out, and sells them in the market for what he can get.

In other words, it is the fact of proprietorship. To obtain an income of profit, the co-ordinator must own or control the things he co-ordinates. Professor Clark indeed asserts that this ownership, though a necessary one, is still a mere incident; but I am confident that, if he will reconsider the matter, he will recognize that it is really the very essence of the matter in dispute, and that he does not differ from me as radically as he supposes.

Now it must be granted that it is impossible for any one to earn a profit without performing an act of co-ordination.* And it is equally impossible to do so without some amount of physical effort. So, also, it is impossible to make a loan without expending a small amount of personal exertion and performing at least one act of co-ordination; but no one on that account considers the loaning of capital to be a mere incident to the exertion of finding a trustworthy borrower, and that, consequently, interest is the reward of labor and a kind of wages. On the contrary, it is the personal exertion or labor of arranging the loan which is incidental to the capitalistic function of loaning. And, in exactly the same sense and degree, any acts of co-ordination performed by the *entrepreneur* are merely incidental to his ownership of the enterprise. If such acts of co-ordination are performed wisely, the *entrepreneur's* income will indeed be increased; but so,

* For, even when everything is left to a hired manager, his selection is an act of co-ordination, though it may be and sometimes is the only act of co-ordination performed by the profit-recipient.

also, will the income of the capitalist be increased by personal diligence and good judgment. The cases of the capitalist and of the *entrepreneur* are not merely analogous: they are absolutely parallel, the only difference being that ordinarily the affairs of capitalists require less personal attention and less co-ordinating than the affairs of *entrepreneurs*.

Now why is it that this fact of the ownership of the *entrepreneur* is so significant? If both selling price and cost, inclusive of his own wages of management, were absolutely predetermined and certainly known to everybody else as well as to himself, would there be any such thing at all as profit? Manifestly not, for then cost and selling price would always equal each other, unless the producer enjoyed some personal or monopolistic advantage that kept others from competing with him; and in this case his additional income, above wages of management, would be entirely a monopolistic gain. There exists a quite common business arrangement which aptly illustrates this condition of affairs. It is that of the broker who buys on order, and, on occasions (for the purpose, usually, of keeping the two apart) has the goods charged to him by the seller, and then bills them at the same price to the buyer, and sends in a bill for brokerage either to the buyer or to the seller or to both. There is, of course, a small element of risk to the broker in this transaction; but the additional business thereby secured is considered by him to be the equivalent or more than the equivalent for the risk. There is here no real difference between cost and selling price. If the broker possesses influence, good will, or other personal advantages which enable him to secure more brokerages than his personal labors are really worth, his income consists wholly of wages of management plus some gain from monopoly. We have here both coordination and ownership and yet no element of profit, from which it appears that the peculiar income of the

entrepreneur arises neither from co-ordination *per se* nor from ownership *per se*. The element of "profit," however, or of its complement, "loss," is attendant upon co-ordination when co-ordination happens to be an incident of ownership; and it is attendant upon ownership only so long as either cost or selling price is undetermined, so long only as ownership involves risk.

In the last analysis an act of co-ordination cannot possibly be anything more than the exercise of a choice. If I am correct in this, it would seem to settle the question between the mere co-ordinator and the enterpriser in favor of the latter. The co-ordinator is the one who makes the choice, who decides; and this he can do either for himself or for others: the enterpriser is he who assumes the consequences of the choice, whether the choice be made by himself or by others acting as his agents. When the two happen to be different persons, it is not the chooser, but the assumer, who gains or suffers by the transaction. Consequently, when the same person happens to be both chooser and assumer, both co-ordinator and enterpriser, the results of the choice accrue to him as "enterpriser *per se*," and not as "co-ordinator *per se*." At the time of choice the results of the choice are necessarily undetermined. It is, therefore, only the "enterpriser *per se*" who is entitled to the undetermined residue or profit of the transaction.

That there is an ever-present and indissoluble connection between risk and profit seems now to be proven. This same relation of risk to profit can perhaps be made more evident to some minds in another way, or, rather, in another form of words, the logical process being really the same. All are agreed that profit is a residue; but, until any transaction is completed, what the residue will amount to is a matter of uncertainty. The class of producers, therefore, who consent to accept this uncertain residue as their share of the product, assume a risk; and

part, at least, of the residue must be considered as their remuneration for the assumption. Even if we should grant — what is no longer possible — that wages of management and monopoly gains are components of this residue, the fact that these wages and gains were not predetermined would leave in the residue an element of risk entitled to compensation. We see, therefore, that residue connotes risk, and that risk connotes residue: the two are inseparable. Now, if residue and profit are connotations, and residue and risk are also connotations, it is a necessary corollary that profit and risk connote each other.

Now how does it happen, if I am correct, that so able a thinker as Professor Clark overlooked these connotations? The explanation can, I think, be found in the very title of his paper, "Insurance and Business Profit." Used in this connection, the word "insurance" carries with it the unconscious implication that it is the reward for assuming a risk; and, as an insurance premium is always a predetermined sum, the vital connection between the reward of risk and undetermined residue is obscured. Insurance is an element of cost, as Professor Clark rightly claims, whether such insurance is paid by the *entrepreneur* to the owner of the plant which he rents or to the capitalist whose funds he borrows as a protection against fire in the one case and against his own failure in the other case; and in both cases such insurance lessens the undetermined residue which constitutes profit.

Now, if I am correct in claiming that enterprise is the real function of the *entrepreneur*, what actually occurs is exactly what the Risk Theory of profit would lead us to expect. Whenever any given *entrepreneur* shifts his function upon another by insurance, his own expectation of reward is cut down. If his risk of fire is 1 per cent., and he insures the risk at 2 per cent., his expectation of profit is just 1 per cent. less than it was before. On the other hand, if Professor Clark is right, and profit is the

reward of co-ordination, the *entrepreneur's* expectation of gain should be increased by the above transaction, because his insuring his property against fire is an additional act of co-ordination; and an increase of co-ordination, other things being equal, should lead to an increase of reward.

Of course, as Professor Clark says, no man who has nothing in the shape of a guarantee can assume a risk; but it does not follow from this as a corollary fact that "it goes without saying that the hazard of business falls upon the capitalist." As I have elsewhere shown, the hazard of business can fall upon land or labor, as well as upon capital. This objection, however, does not go to the root of the matter. The real reply is that the reward of the *entrepreneur* is due to him, not because he is the possessor of an opportunity, but because he avails himself of the opportunity. It is not the power to exercise his peculiar function, but the actual exercise of it that brings him gain. It is not because he possesses brain power or muscle that a laborer can earn wages, but because he exercises these powers productively. The miser who buries his gold is not a capitalist. He only is a capitalist who loans his wealth to others or to himself for productive purposes. A man is not an enterpriser simply because he has something which he could risk, be that something accumulated wealth, appropriated natural resources, physical or mental ability, monopoly privileges, or even character and reputation, but because he actually risks these things or some of them in the process of production.

But it may be asked, Why can we not regard the reward of risk as accruing in the shape of an additional award to the industrial force subjected to the risk, as Professor Clark has done in the case of the capitalist? In other words, why are we not at liberty to treat the gain of enterprise as the writer himself has treated the gain of monopoly? A moment's consideration will supply us with a reply. Monopoly is only a distributive force,

whereas enterprise is a creative, or productive, force,—a distinction which is fundamental in economics.*

In his lately published work, *The Distribution of Wealth*, Professor Clark correctly claims that "profits" tend to decline as static conditions are approached, and would be eliminated entirely if static conditions should be fully attained. Whichever we regard as the source of profit, both co-ordination and enterprise are surely dynamic forces. To eliminate profit wholly, however, static conditions must be more absolute than is indicated in Professor Clark's work. Not only must labor and capital remain unchanged in their aggregates,—individual laborers remain constant in their efficiency, and individual capitalists neither increase nor diminish their resources; but, to insure perfect fixity of both cost and amount of production, there must be a cessation of all variations due to the changeableness of the environment; due, that is, to such causes as the progress of the seasons, fire, lightning, hail, the dangers of the sea, and even those incident to natural

* Professor Clark's acknowledgment that enterprise is a productive force is to be found in the following extract from his essay on "Insurance and Business Profit": "Professor Mangoldt in Germany and Mr. Frederick B. Hawley in this country have made a definite contribution to our knowledge of the principles governing business risk and its reward. Working independently, they have reached one conclusion that cannot be overthrown. In a sense there is a net gain realized from risk-taking. Men do not hazard their capital for an amount of annual gains that in a long term of years will just offset their losses. They demand more than this, and get it. If the chance of losing one's entire capital in a year be as one in a hundred, the natural offset for this hazard will be a gain of more than 1 per cent. of the capital exposed. If, of a hundred men engaged in a particular business, one fails each year, the ninety-nine will get enough to more than make good, to the group as a whole, the destruction of capital entailed by a single failure. The wealth represented in this department of business is not only kept intact, but is increased by virtue of a gain that is the direct reward of risk-carrying. To every other industry, and therefore to society as a whole, there accrues each year an accession of wealth that is the offset for perils encountered. Business repays men, not only for their labors, but for their fears." *Quarterly Journal of Economics*, vii. 40. Later in the article he demonstrates with beautiful clearness and conciseness just how the assumption of risk creates value by rendering a service in transferring risks from those to whom their subjective value is great to those to whom their subjective value is less.

growth and decay. We must imagine industrial society in the static condition as an automatic machine, endowed with perpetual motion and working without friction in an absolutely unchangeable environment. Under such circumstances, according to the Risk Theory of profit, profits would of course disappear, because no uncertainties would remain. The Risk Theory is, therefore, entirely in accord with Professor Clark's line of argument in his book.

On the other hand, something more than Professor Clark has yet given us is needed to bring the Co-ordination Theory of Profit in accord with his theory of statical conditions. If the "reward of risk" insures to the capitalist as such, and not to the *entrepreneur* as such, it is either a kind of interest or it is a peculiar form of income, differing from either wages, interest, or profit. In the latter case it should not have been omitted from Professor Clark's analysis. In the former case should he not have explained to us why, unlike other forms of interest, it tends to disappear as the static state is approached? As cost and selling price become more and more fixed, as uncertainties become certainties, risks cease to exist; and the rewards of risk are, of course, no longer attainable. But this growing fixity of cost and price, this decrease in uncertainty, as the static condition is approached, is the very reason Professor Clark advances to explain the decline of profit and its final extinction when the static condition is completely attained. If, therefore, Professor Clark is correct in refusing to identify the "reward of risk" with "profit," are we not entitled to an explanation of the fact that all the influences and tendencies affecting profit, to which he has called our attention, are exactly the influences and tendencies which must affect the "reward of risk," and to have pointed out to us, if they exist, such influences and tendencies as affect these forms of income differently, and which will therefore serve in differentiating the one from the other?

Enterprise is then entitled to a standing in the theory of economics at least alongside land, labor, and capital. It is attended, however, by one peculiarity, which may perhaps be regarded as taking it out of their class, *but by placing it above them* in a class by itself. It is the directive, or governing, force, to which all the other industrial forces are subservient. Land, labor, and capital are but tools in the hands of enterprise. They can each of them exact a specified and predetermined part of the product from enterprise, but only by making themselves subservient to the commands of enterprise. It is the enterpriser alone who decides upon the direction which labor shall take and the form which capital shall take; and he decides primarily with an exclusive view to his own interest, and only secondarily with any consideration for theirs. He is forced, of course, to allow them a sufficient part of the product to keep up their efficiency as his tools; but he will never do anything which will lead to an increase of rent, wages, or interest, unless an increase of his reward is also involved.* So far, then, from its being improbable, as Mr. Haynes fears, that the recognition and proper classification of enterprise will be fruitful in economics, it can be confidently asserted that it is only from the standpoint of the enterpriser that a truly proportioned survey of the economic field can be obtained, because we cannot arrive at any satisfactory comprehension of the interaction of industrial forces until we have obtained an understanding of the initial force that sets them all in motion.

Returning now to the subject of insurance, which re-

*Thus, if a new process were proposed to an enterpriser, by means of which he could obtain the same product with the labor of 51 men at $2 which he was producing by the labor of 100 men at $1 per day, he would refuse to adopt it, because it would entail a loss to him of $2 per day, notwithstanding the fact that the adoption of the process would result in addition to gross wages of whatever the 49 discharged men could earn in other occupations. Supposing they could secure equally good wages elsewhere, this would mean a gain to the world of $47 per day, less the cost of educating 51 men worth $1 per day into $2 per day men.

quires further analysis, I would say that, so far from being a synonym for "reward of risk," as it is tacitly assumed to be by most writers, it is really its antithesis. To the party who pays a specific sum to free himself from a risk, insurance is not the equivalent of what would have been his reward for undergoing the risk. It is what is paid for avoiding the risk by transferring it to the shoulders of another. Nor does the second party, in accepting the premium of insurance, which Professor Clark speaks of as "the offset of the risk," receive it as his reward for the assumption of the risk. His real reward is to be found, not in the amount of premium received, but in the difference between that amount and the losses consequent upon assuming the risk; and in any individual case the reward may be therefore a negative one. When similar business transactions are aggregated, however, the sum of the premiums will always exceed the sum of the losses; and, therefore, in any general treatment of the subject, we are justified in regarding the insurer's reward as a positive one, so long as we do not fall into the error of considering the premium of insurance received as the insurer's reward. His net reward, after his expenses and wages of management are deducted, is a pure profit or loss, because, although the selling price of the guarantee he has given is fixed and predetermined, what the guarantee will cost him can only be determined by the expiration of the risk. The *entrepreneur* ordinarily has his costs or most of them determined before his selling price; but the insurer (and the *entrepreneur*, also, who sells his goods before he makes them) has his selling price determined before his costs. This, however, makes no theoretical difference, as there is equally an undetermined residue, whether it is selling price or cost which is first determined.

When the capitalist gets 2 per cent. extra in his gross interest to induce him to make a hazardous loan, his real

gain is not this 2 per cent. received, unless it so happens that his loan is repaid at maturity. Taking all hazardous loans together, as we should do in a general treatment of the subject, we see that capitalists receive a predetermined pure net interest on their capital, and an indeterminate sum besides, to reward them for their risk; that is, really an undetermined difference between cost and selling price, which, according to all disputants, is the definition of profit. The inducement to make a hazardous loan is not the gross amount of the premium exacted, but the difference between that premium and the probability of loss. In other words, considered from the general point of view, gross interest, as the term is ordinarily used, is a composite sum composed of pure interest, recoupment of actual loss, and profit, the first being a predetermined sum and the two others also predetermined in their aggregate, but varying inversely, and, therefore, undetermined separately. The first and third only are income of the combined owner and risker of the capital loaned, whose income is clearly a composite one, composed of two clearly distinguishable elements, which are subject to two entirely different sets of influences and laws. To obtain the second part of this composite income, the owner of the capital has exercised the function of the enterpriser; and it is curious to observe, and confirmatory, also, of the position I am advocating, that he was only able to exact this premium over pure interest because individually he did not at the time come under the definition of the "capitalist as such." The "capitalist as such" cannot be the owner or possessor of capital. That is universally conceded to belong to the function of the "*entrepreneur* as such." What the "capitalist as such" possesses is simply a *claim* on capital which is actually in the possession of some other *entrepreneur*, or in his own actual possession as an *entrepreneur*, if he employs his capital himself.

But it is precisely because the lender has the actual possession of the property at the time the loan is made that he is able to exact a premium for the risk. It goes without saying that a man cannot risk what he does not own or control; and, as the actual possession of capital is an attribute of the *entrepreneur*, and not an attribute of the capitalist, it is the *entrepreneur* alone who can risk it.

Now it does not follow that any individual *entrepreneur* cannot insure some of the risks inseparable from the business in which he is engaged; but we should expect he would in each case reduce correspondingly, or nearly so, the reward for risk that would otherwise accrue to him. And this is just what happens. A premium of insurance becomes a cost to the one who pays it, and is always a deduction from the undetermined residue. But, while it is true that the actual risk is not at all lessened by being transferred, it is always transferred to broader shoulders, because the assumer's subjective valuation of the risk must always be lower than the subjective valuation of the insured, from which it follows that the selling price of the product will be correspondingly reduced by competition. Let us suppose that in a given enterprise the real risk of destruction by fire is 1 per cent. of the product. A fire would, however, be such a serious calamity to an individual *entrepreneur* that he would require 5 per cent. of the product to induce him to take the chance. When insurance companies offer to relieve him and his competitors, also, of this risk for 2 per cent. of the product, competition would soon reduce the selling price by 3 per cent., from which it clearly appears that a premium of insurance paid by an *entrepreneur* really represents only a part of the real cost of his insurance, as eventually the competition of other *entrepreneurs* will lead to a lowering of selling price. In the case just cited the *entrepreneur* would have gained, on the average, one year with another, an additional 4 per cent. profit and selling price

would have been 3 per cent. higher if fire risks were uninsurable.

Looking at the matter from the standpoint of the individual *entrepreneur*, it has been perceived that he can shift some of his risks by the payment of a sum agreed upon or predetermined, from which circumstances both Professor Clark and Mr. Haynes tacitly assume that all his risks could be so shifted without the abandonment of his special function. It would follow — as the aggregate of a number of predetermined sums must be itself a predetermined sum — that the cost of shifting the whole risk assumed by the *entrepreneur* must be considered a predetermined sum; and, as this cost is considered by them to be the reward of risk, the reward of risk cannot be a residue, but must be considered as a cost. We have already noticed the fallacy of regarding insurance as the reward of risk. But the argument contains another fallacy even more radical. It lies in the supposition that the *entrepreneur*, even in their definition of the term, can shift all his risks by means of insurance without entirely abdicating his special industrial function. The risk involved in his ownership of the product can only be terminated by his parting with the product,— an act which is the *finale* of any industrial transaction. This act completed, the undetermined residue is determined, the uncertain profit becomes realized and definite, and the *entrepreneur* has ceased to exercise his peculiar industrial function.

This brings us to the last division of our subject,— speculative risks, as they afford an example of a special case where the *entrepreneur* appears to insure his last risk, that of "selling price"; to insure, that is, the risk I have called an uninsurable one. I refer to the case of the miller of flour to which Professor Emery calls attention. It so happens that I am practically as well as theoretically familiar with operations on the Exchanges. Let

us consider, then, transactions in an important and typical commodity,— cotton.

Every conservative dealer sells "futures" against his purchases of actual cotton, and buys "futures" against his sales of actual cotton. It may seem to the uninitiated that such a sale of "futures" is a virtual insurance of "selling price" and such a purchase of "futures" a virtual insurance of "cost." And, to a certain extent, this is true. When the actual cotton is purchased for the purpose of delivering it on the "future contract" sold, there are, however, several elements of uncertainty yet uneliminated. The cotton may be damaged in transit; it may lose in weight; it may not grade as well as expected; it may be too long in transit to reach the market in time for delivery; the allowance for grade may vary before delivery; the carrying differences between the months may change; and so on. Usually, however, the cotton bought is not suitable for "contract delivery" which will entail additional uncertainties. It may, for instance, be of superior staple and character, which command a premium not allowed for on "contract deliveries," or it may have been bought with reference to a prospective customer for whose use it was especially fitted, and a premium paid for it on that account. In short, the circumstances other than the fluctuation of price on the Exchange which affect the selling price of a "hedged" lot of cotton are almost numberless. It is safe to assert that, as a matter of fact, not 10 per cent. of the actual cotton handled by New York dealers could be "delivered on contract" without loss. It is evident, therefore, that the risks influencing selling price are never wholly eliminated by the process of "hedging." Nevertheless, a great part of them are thus eliminated; and the consequence is that actual cotton is handled on a margin of profit so small that it often hardly exceeds a brokerage, and yet the business yields, perhaps, the average return on capital. The reason is that with

the decrease of risk and of profit on each transaction there takes place a corresponding increase in the number of transactions possible with the same amount of the dealer's own capital. It is not an unheard of thing for the cotton market to advance 100 per cent. or to decline 50 per cent. from the opening price within a year. The merchant who should embark his whole capital in such a variable commodity would be altogether too venturesome. Unless the expectation of average gain was very great, the moderately prudent man would not engage in the business at all, or, if he did, he would invest only such small part of his funds as he could spare without much inconvenience. On the other hand, when cotton is "hedged" on the Exchange, dealers can safely carry cotton to several times the amount of their capital. Hedged cotton is such a good security that borrowing on it is safe for both borrower and lender, because the limits of the variation in the "uncertain residue" when it is finally determined will be found to be unusually near together. It is a very rare thing for actual cottons bought to be carried and sold again on the Exchange, to net a loss of over 2 per cent. or to show a profit of over 5 per cent.; and, perhaps, the average dealer in "hedged" cotton would be fairly well satisfied if his purchases realized him a net average gain of 2 to 3 per cent., whereas, if "options" were prohibited, as is desired by our Populist friends, dealers would have to obtain on the average from 6 to 10 per cent. of the selling price, to yield them the same percentage of return on their capital and the increased reward which the greater risk would inevitably result in.

The middleman who does not hedge his cotton has his average remuneration fixed by his competitor who does hedge; and he can therefore get absolutely nothing in the long run for retaining the risks he might shift by hedging. Of course, during an advancing market he

makes enormous profits; but he suffers corresponding losses when the market declines. If he attempts to charge for this additional risk, his prices will be higher than the prices at which his more conservative competitors are glad to sell. The operations of the cotton exchanges, therefore, reduce the aggregate gains of middlemen by perhaps 50 per cent., the benefit going, of course, eventually to the final consumers of cotton goods. The individual middleman loses nothing by this process, as he is able with the same capital to do enough more business to offset his reduced gain on each separate transaction. What the class loses is in its numbers: there will be found to be only half as many of them as before.

Now we find in the cotton speculator a person who performs a real and very valuable industrial service. Is he an *entrepreneur?* He certainly assumes a considerable part of the risk of variation in the selling price of a great commodity,—a risk which, when assumed by dealers in other commodities, yields them, on the average, a very substantial income of profit. Why does not the profit, or, at least, a part of it, as in other cases of insurance, follow the risk? And how can it be demonstrated that it does not?

The mere speculator in cotton is not an *entrepreneur* so long as he remains a mere speculator, because he has not, in buying his "futures," acquired any ownership in any actual cotton, but only a claim to have cotton delivered to him at a certain time at a certain price. When such a delivery is made, he becomes an *entrepreneur*, and is sure to realize a gain or suffer a loss independent of his gain or loss due to fluctuations of the market. But, unless his "future contract" terminates in the transfer of real cotton to him, he lacks the ownership which would enable him to obtain a profit,—a profit which would appear in the price paid by the consumer. But the fact that speculators in cotton as a class get nothing in the

long run as a reward for running the risks they assume can also be mathematically demonstrated. For every sale on the Exchange there is a corresponding purchase. The long and the short side are always equal to a bale. Some of the sales, however, are against cottons held by dealers or against cottons the planter has or expects to obtain from his growing crop. Occasionally, also, a purchase of cotton "futures" is made by a spinner as a hedge against a sale of manufactured goods, to make which will require more cotton than he cares to buy at the moment. There is always, however, a large balance of hedging sales over hedging purchases. Consequently, when the market advances, speculators as a class do make money; and holders of hedged cottons forego an equal amount of gain, which they would have secured if they had acted less conservatively. But, when the market declines, the process is reversed; and the speculators lose money to just the amount that the holders of hedged cottons save. As, in the long run, rises in price must exactly equal declines, speculators as a class neither make nor lose by their operations,* except, of course, the loss of the expenses they incur in the conduct of their speculations, such as for office rent, clerk hire, and brokerages. There is, of course, a class of individuals who acquire fortunes, and sometimes very large ones, by speculation on the Exchanges, whose success is by no means due to luck or good fortune, but to sound judgment, pluck, and wide knowledge both of men and affairs. Their gains are at the expense of less able and less well-informed venturers. If all speculators were equally well equipped, none of them could make any money except as a matter of pure luck, as then the price of cotton on the floor of the

*This is strictly true only under the supposition that on the average as much cotton is "hedged against" in rising as in falling markets. As a matter of fact, as large stocks depress prices, more cotton is "hedged against" in falling markets, so that on the whole mere speculators must lose more than they gain; but the percentage of loss on their total operations is trifling.

Exchange would be exactly what it really ought to be, and would vary only on the occurrence of circumstances that no one could have foreseen.

Now I think I have made it evident that Dr. Wood was mistaken in his remarks before the American Economic Association when he assumed that a theory of profit must account for the gains of speculators on the Cotton and Produce Exchanges; also, that President Hadley was laboring under a misapprehension — very pardonable in a professional man — when he implied that these speculators performed the service of "carrying goods over from time to time." We have seen that they never possess the ownership which would render that possible. To "carry goods over from time to time" is, of course, a function of the *entrepreneur*, or enterpriser; and, whether the carrier is a manufacturer, a jobber, a wholesaler, or a retailer, he is exercising a useful industrial function, for which he rightly receives a composite income of interest, wages of management, and profit. He is not a speculator at all, in any proper sense of the word, and should not be spoken of as such except in that loose use of the term which signifies an over-venturesome person. The forestaller, however, although no more a speculator than the jobber, stands on a little different footing; that is, he is a jobber who seeks, by "cornering the market," to add a monopoly increment to his legitimate profit.

The answer, then, to the inquiry of Professor Emery contained in the able paper which he read before the American Economic Asssociation is that the speculator has no place at all in the theory of distribution, or, what would be a better name for it, in the theory of productive distribution. That theory, as I understand it, has only to do with the division of the product among those who contribute to its creation. It is concerned only with industrial incomes, and does not consider what the recipients of income do with it, except, perhaps, so far as their ex-

penditure reacts upon their ability to continue their productive activity. If these recipients elect to give away, gamble away, or spend foolishly, what they have earned and received of rent, wages, interest, or profit, the theory of distribution does not have to accommodate itself to the explanation of their actions in so doing.

We have now, I think, attained a position from which we can clearly discriminate between the three classes of risk-takers,— enterprisers, speculators, and gamblers. All of them are actuated by the hope of gain, but differ in their grounds for expecting or hoping for gain. The *entrepreneur*, who is the only assumer of industrial or productive risks, when considering a risk, computes as well as he can the actual probability of loss. He then forms a subjective valuation of the risk, which is, of course, considerably greater than the actual risk. The difference between his actuarial and his subjective valuation serves as the minimum limit of the expectation of profit which will induce him to assume the risk. He then secures from the person who will be relieved by his assumption of the risk as much as he can for assuming it, the maximum limit being, of course, that person's subjective valuation of the risk, which must in all cases be greater than his own, or no transaction results. The competition of enterprisers among themselves results, of course, usually in the enterpriser getting but little more than his own subjective valuation; but a little more he does always get in the long run. The essential point, however, is that the enterpriser performs a service for which he expects to receive a reward,— necessarily, from the circumstance of the case, uncertain in its amount, or, in other words, a true residue.

The speculator, on the other hand, does not render, or rather does not mean to render, any service to anybody. The fact that a speculator on the Cotton or Produce Exchange does render a service to society through the party he relieves of the risk is, as we have seen, only in-

cidental. The speculator on the Stock Exchange, whose operations are otherwise similar to his, relieves no one of the risk of what the selling price of the product will be, as the subject matter of his speculations is not products but aggregations of capital that produce products. All that the pure speculator has in mind, when he assumes a risk, is to back his own opinion. He believes that the common judgment of the trade about the real value of cotton or wheat or stocks, as expressed in the prices ruling on the Exchange, is wrong, just as he may believe that a certain horse may have a better chance to win a race than is expressed by the going odds. Some of these men are correct in their estimate of themselves: their judgment of cotton, wheat, stocks, or horses, is better than that of the average man venturing in these matters. These men win largely and steadily, but it is only because they excel their fellow-speculators. If the average was raised to their level, they would have no advantage in speculation; and they would cease to win with any approach to regularity, and in the long run would neither gain nor lose by their ventures. Speculation is, therefore, merely a distributive force, and cannot be brought by analysis within theories of the productive forces.

The case of the gambler differs from that of the speculator only in this: that his subjective valuation of a risk is a negative quantity. The excitement of risk makes it, to the gambler, a good in itself, so that, when he believes the chance of winning or losing to be even, he likes to take the chance when opportunity offers; and when he cannot find an even chance to bet on, without putting himself to too much trouble, he will play faro or some similar game in which he knows that the chances are against him.

It is curious to observe, however, that the keeper of the faro bank, or "banker," who is often spoken of as the gambler *par excellence*, is not a gambler at all. And

the popular diction recognizes this in another common form of words. This man is called a "professional gambler," a "man whose business is gambling." And the popular intuition is correct. The "professional gambler" is a business man, an *entrepreneur*, an enterpriser. He assumes a risk, and looks to an undetermined residue for his reward. In assuming the risk, he performs a service by affording real gamblers an opportunity to gratify their passion for excitement and dissipation. The fact that the service is disreputable does not affect its economic character.

So long as the above distinctions between the enterpriser, the speculator, and the gambler, are not clearly apprehended (and that they are not yet so apprehended by our leading economists appears very plainly in the discussion which followed Professor Emery's paper at the meeting of the American Economic Association), it is not to be wondered at that economists shrink from allowing enterprise a coequal place alongside land, labor, and capital. This natural reluctance, together with the almost universal custom of regarding insurance, because a definite sum paid for assuming risk, as therefore itself the reward for risk, which reward could not on that account be an undetermined residue; and the neglect to subject the term "co-ordination" to the careful analysis which could not have failed to show that "co-ordinating" is only a kind of labor, and not entitled, therefore, to any such reward as a profit, because profit and wages are fundamentally distinct,—these considerations appear to me to afford the probable explanation why the Risk Theory of Profit has met with the cool and half-hearted reception which has so far been its fate, and have led me to ask in this article a reconsideration of the evidence.

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